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versight Report



CONTRACT AUDIT DIRECTORATE

DoD Oversight of Defense Contractor Insurance and Pension Plans

Report Number PO 97-013

March 28, 1997

Office of the Inspector General
Department of Defense

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Acronyms

ACO	Administrative Contracting Officer
CAS	Cost Accounting Standards
CAM	Contract Audit Manual
CIPR	Contractor Insurance/Pension Review
DCAA	Defense Contract Audit Agency
DCMAO	Defense Contract Management Area Office
DCMC	Defense Contract Management Command
DCMD	Defense Contract Management District
DDP	Director, Defense Procurement
DFARS	Defense Federal Acquisition Regulations Supplement
DLA	Defense Logistics Agency
FAR	Federal Acquisition Regulations
GAS	Government Auditing Standards
I/P	Insurance/Pension
MOCAS	Mechanization of Contract Administration Services



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March 28, 1997

**MEMORANDUM FOR DIRECTOR, DEFENSE PROCUREMENT
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY**

SUBJECT: Evaluation Report on DoD Oversight of Defense Contractor Insurance and Pension Plans (Report No. PO 97-013)

We are providing this evaluation report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations and potential monetary benefits be resolved promptly. As a result of management comments, we added Recommendation A.1.c to the Director, Defense Logistics Agency; Recommendations A.2.c and A.2.d to the Director, Defense Procurement; and revised Recommendations B.1 and B.2.a. We also added Recommendation A.3 to the Director, Defense Contract Audit Agency. Therefore, we request that management provide comments by May 28, 1997, on the additional recommendations and the time schedule for implementing actions.

We appreciate the courtesies extended to the Policy and Oversight staff. Questions on the evaluation should be directed to Mr. Maurice G. Nestor, Program Director, at (703) 604-9102 (DSN 664-9102); Ms. Madelaine E. Fusfield, Project Manager, at (703) 604-9190 (DSN 664-9190); or Ms. Suzanne J. Servis, Project Manager, at (703) 604-9182 (DSN 664-9182). See Appendix F for the report distribution. The evaluation team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. PO 97-013
(Project No. 6OC-0092)

March 28, 1997

DoD Oversight of Defense Contractor Insurance and Pension Plans

Executive Summary

Introduction. We performed this evaluation as a followup to our review on the same subject, Report No. APO 93-011, "DoD Oversight of Defense Contractor Pension Plans," May 7, 1993. That evaluation found that the Defense Contract Management Command did not manage pension reviews effectively and did not aggressively pursue outstanding issues involving pensions. Also, the Defense Contract Audit Agency participation in pension reviews under the team leadership of the Defense Contract Management Command was limited.

Evaluation Objectives. The evaluation was initially announced under two project numbers: 5CPO-046, "DoD Oversight of Defense Contractor Pension Plans," and 6CAF-019, "DoD Oversight of Contractor Insurance/Pension Issues." Because the findings of the two projects are related, we consolidated them and established Project No. 6OC-0092 for report purposes.

The overall objective of Project 5CPO-046 was to determine whether the Defense Contract Management Command had implemented agreed-to recommendations to improve planning, documentation, and coordination of the reviews. We evaluated the overall adequacy of pension review coverage, including the use of audit support services and the overall quality and extent of audit services the Defense Contract Audit Agency provides to the Defense Contract Management Command.

The objective of Project 6CAF-019 was to evaluate whether DoD contracting officers were actively pursuing resolution and disposition of findings in Contractor Insurance/Pension Review reports, including whether the Defense Contract Management Command was maintaining accurate data on the reports in the Mechanization of Contract Administration Services contract audit followup data base.

Evaluation Results. Billions of dollars of contractor pension fund assets, accumulated from charges to Government contracts, continue to be exposed to undue risk due to inadequate and untimely reviews of contractor pension plans. Based on estimated average pension costs of \$216,000 per employee, the pension fund assets--for the 15 largest contractors alone--is estimated to be \$100 billion. Our prior evaluation of the Contractor Insurance/Pension Reviews, required by the Defense Federal Acquisition Regulations Supplement 242.73, reported on this vulnerability in May 1993, but our recommended corrective action was not implemented. The required reviews do not

adequately test contractor compliance with contract terms, placing Government contracts at risk of excessive charges due to improper allocations and inflated estimates in pricing new contracts. The untimely reviews render pension fund assets vulnerable during contractor reorganizations (Finding A).

o The Defense Contract Management Command does not properly plan, document, and coordinate the insurance and pension reviews with the Defense Contract Audit Agency.

o Few Insurance/Pension Specialists are adequately trained to review pension plans or to perform tests for compliance with the Cost Accounting Standards and Federal Acquisition Regulations governing pension costs. The Specialists are trained insurance examiners but have insufficient knowledge to understand pension funding requirements.

o The Defense Contract Audit Agency performs limited reviews of insurance and pension programs due to limitations imposed by the Defense Federal Acquisition Regulations Supplement.

o The Defense Contract Management Command generally has not performed timely reviews of pension and insurance programs in connection with business reorganizations. Unless reviews are timely, contractor forward pricing rates may not be updated and negotiated contracts may be adversely affected.

The reviews also do not provide contracting officers with sufficient technical information to resolve and disposition findings in a timely manner. Pension issues are complex and require the support of technical advice that is often not available, and contracting officers are inadequately trained to negotiate resolution and disposition of those issues (Finding B).

The above conditions result in unacceptable review coverage and substantial risk to the Government that incurred costs are improperly allocated to Government contracts and forward pricing estimates for future contracts are inaccurate. The Government must have reliable information to determine whether Government-funded pension assets will continue to be available to offset future retirement benefits for employees performing on Government contracts.

Recommendations in this report, if implemented, will help ensure that audits of Government-funded insurance and pension programs are properly conducted and that contracting officers receive adequate technical support and training to timely resolve and disposition findings involving complex pension issues.

Summary of Recommendations. We recommend that the Defense Logistics Agency transfer responsibilities for reviewing insurance and pension programs to the Defense Contract Audit Agency and establish separate technical support teams for reviews of employee benefits. We also recommend that the Defense Logistics Agency require technical specialists to assist auditors during a joint review. The Director, Defense Procurement, should revise the Defense Federal Acquisition Regulations Supplement to

reflect the transfer of responsibilities and to require timely special reviews. The Director, Defense Contract Audit Agency, should direct auditors to comply fully with Government Auditing Standards and Federal Acquisition Regulations on Cost Accounting Standards administration.

Management Comments. The Director, Defense Procurement, and the Defense Logistics Agency nonconcurred with our recommendation to transfer program responsibility to the Defense Contract Audit Agency and also with the recommendation to conduct separate reviews of insurance and employee benefit programs. However, both agreed to create a joint review program. They believe the joint program should resolve coordination problems between the two agencies and facilitate timely reviews of insurance and pension costs when pricing future contracts.

The Director, Defense Procurement, concurred with our recommendation to require special reviews, instead of routine biennial reviews, of insurance and employee benefit plans before major contract awards, in conjunction with an in-depth overhead review, or subsequent to mergers, acquisitions, divestitures, and significant pension plan changes. Also, reviews are to be based on risk assessments and not routinely required.

The Defense Logistics Agency partially concurred with our finding that Contractor Insurance/Pension Reviews do not test contractor compliance with complex regulatory provisions and the biennial reviews are not timely to meet Government needs. However, the Agency nonconcurred with our conclusion that Finding A constitutes a material management control weakness. The Agency believes that certain special reviews sufficiently protected the Government's interests.

Evaluation Response. We conditionally accept the proposed actions based on the Director, Defense Procurement, and the Defense Logistics Agency commitment to improve Contractor Insurance/Pension Reviews and the Defense Contract Audit Agency reluctance to assume primary responsibility for the Contract Insurance/Pension Review program. Acceptance of the proposed action is conditional to Defense Logistics Agency also implementing the added Recommendation A.1.c. Because we recommended 4 years ago the improvements the Director, Defense Procurement, and the Defense Logistics Agency now propose to implement, we plan to closely monitor new procedures to ensure they are timely and effective.

We do not agree that implementing our 1993 recommendations is alone sufficient to correct all planning, coordination, and documentation problems. Review programs are frequently revised to fit particular circumstances. If a technical specialist as team leader has the authority to revise the joint review program to deemphasize audit procedures, coordination difficulties will continue and review coverage will suffer. Although auditors need technical assistance to review insurance and employee benefit programs, auditors should fulfill their primary responsibility for testing and determining contractor compliance with the Cost Accounting Standards as outlined under the Federal Acquisition Regulations. They must also have responsibility for determining the scope of the audit to comply with Government Auditing Standards.

In its final response, the Defense Logistics Agency should explain how the required various technical experts will be provided for a single review of contractor insurance and employee benefit programs considering the current and anticipated differences in the number of trained specialists for each review area. We request final comments and a schedule of planned corrective actions by May 28, 1997.

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Part I - Evaluation Results

Evaluation Results

Evaluation Background

Contractor Insurance/Pension Reviews (CIPRs) are performed to evaluate contractor insurance programs, pension plans, and other employee benefits plans. Contractor policies, procedures, and practices are reviewed to determine whether insurance and employee benefit costs charged to Government contracts comply with the Federal Acquisition Regulations (FAR), Cost Accounting Standards (CAS), and contract clauses. The Defense Federal Acquisition Regulations Supplement (DFARS) Subpart 242.73 provides that CIPRs should generally be conducted every 2 years but may be conducted on a more or less frequent basis. CIPRs are performed on contractors that have actual or anticipated qualifying annual sales to the Government of \$40 million or more on negotiated prime contracts or subcontracts. Qualifying sales are those negotiated based on certified cost and pricing data.

The Defense Logistics Agency (DLA) is the DoD Executive Agency responsible, through its Defense Contract Management Command (DCMC), for conducting CIPRs. Under the DoD Directive 5105.22, the DLA is to provide scientific and technical information to DoD Components. The DCMC employs Insurance/Pension (I/P) Specialists to conduct the reviews.

On June 27, 1994, the DCMC Headquarters instructed Defense Contract Management District Commanders that CIPR reports with significant findings were subject to DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports." To facilitate proper, timely disposition of findings and recommendations, CIPR reports with significant findings are required to be entered into the DCMC contract audit followup data base.

The Defense Contract Audit Agency (DCAA) performs all necessary contract audits for the DoD procurement and contract administration activities for the negotiation, administration, and settlement of contracts and subcontracts. The DoD Directive 5105.36, "Defense Contract Audit Agency," establishes the Agency's mission and responsibilities. Accordingly, "[no] separate contract audit organization independent of the DCAA shall be established in the Department of Defense." The DCAA auditors are trained to evaluate contractor cost allocation methods to ensure the methods comply with the CAS. When requested, DCAA assists the DCMC in performing CIPRs.

Government Auditing Standards (GAS) encompass general, field, and reporting standards for financial and performance audits. The GAS are applicable to audits performed by DCAA. The GAS address auditor qualifications and due professional care, planning, the need for workpapers, and other standards auditors must adhere to. The purpose of GAS is to provide standards for audits of Government organizations and programs and of Government assistance received by contractors and other non-Government organizations. Public officials entrusted with public resources, in this case insurance costs and pension fund contributions reimbursed on Government

contracts, are responsible for complying with applicable laws and regulations. Audits performed in accordance with GAS are required to assess compliance with laws and regulations.

Evaluation Objectives

The evaluation was initially announced under two project numbers: 5CPO-046, "DoD Oversight of Defense Contractor Pension Plans," and 6CAF-019, "DoD Oversight of Contractor Insurance/Pension Issues." We combined the projects because the findings are related. The overall objective of Project 5CPO-046 was to determine whether the DCMC had implemented agreed-to recommendations in our May 7, 1993, Report No. APO 93-011, "Review of DoD Oversight of Defense Contractor Pension Plans." We evaluated the overall adequacy of pension review coverage through CIPRs, including the use of audit support services and the overall quality and extent of audit services the DCAA provides to the DCMC. Although CIPRs cover employee benefits other than pension plans and we addressed certain issues related to the review of other benefits, the primary emphasis of our evaluation was on the coverage provided of contractors' pension plans. Pension plans represent the greatest dollar risk to DoD because of the significant amount of assets and liabilities that are susceptible to manipulation during business reorganizations.

The objective of Project 6CAF-019 was to evaluate whether DoD contracting officers were actively pursuing resolution and disposition of findings in CIPR reports, including whether the DCMC was maintaining accurate data on the reports in the Mechanization of Contract Administration Services contract audit followup data base. See Appendix A for our scope and methodology and Appendix B for a summary of prior coverage related to the evaluation objectives.

Finding A. Contractor Insurance/Pension Reviews

CIPRs do not test contractor compliance with the complex regulatory provisions governing costs allocated to Government contracts, and the biennial reviews are not timely to meet Government needs. Lack of trained personnel to review pension plans, conflicting audit responsibilities, and inadequate administrative guidelines in the DFARS contribute to the problem.

- o The DCMC does not adequately plan, document, and coordinate the CIPRs with the DCAA. The DCMC has not fully implemented our prior recommendations for improving review quality (Appendix B).

- o Insurance/Pension (I/P) Specialists are trained insurance examiners but lack the expertise to review pension plans or to perform tests for compliance with the CAS and FAR governing pension costs. The lack of skills are the result of inappropriate DLA job descriptions and the DFARS requirement for a single insurance/pension review of subjects that require different and unrelated skills.

- o The DCAA performs limited reviews of insurance and pension programs because the audit responsibilities in DFARS Subpart 242.73, "Contractor Insurance/Pension Reviews," conflict with the audit responsibilities under FAR Subpart 30.2, "CAS Administration," and lead to violations of the Government Auditing Standards (GAS). Auditors have a subordinate role to the DCMC during CIPRs and cannot independently determine the scope of their efforts.

- o The DCMC does not perform timely reviews of pension and insurance programs in connection with business reorganizations because the DFARS Subpart 242.73, "Contractor Insurance/Pension Review," does not adequately stress the need for the special reviews under certain circumstances.

The conditions reflect material management control weaknesses as defined in DoD Directive 5010.38, "Internal Management Control Program," and require DoD attention. The lack of proper review coverage presents substantial risk to the Government that incurred costs are improperly allocated and budget estimates are inaccurate. Unless reviews are timely, contractor forward pricing rates may not be updated and negotiated contracts may be adversely affected. The Government must have reliable information to determine whether billions of dollars in Government-funded pension assets (see Appendix C) will continue to be available to offset future retirement benefits for employees on Government contracts. The funding and administration of contractor pension plans generally result in more complex regulatory issues than do

Finding A. Contractor Insurance/Pension Reviews

insurance programs and represent greater risk. However, insurance programs, such as employee health insurance, can be costly and also represent risk to the Government for estimating future contract costs.

Contractor Insurance/Pension Reviews

Proper planning is essential to conduct efficient and effective CIPRs. Planning procedures should include risk assessments and a review program for determining the scope of a review and proper allocation of resources to areas involving the greatest risk. Documentation of the work performed to evaluate the measurement and allocation of costs is critical to ensure a comprehensive, logical, and orderly review is conducted.

Reviewers and technical specialists must coordinate during the review to ensure that all planned procedures have been accomplished. A review program should outline the work the different team members will perform to ensure complete and comprehensive evaluation of the subject. A review program guides team members and prevents duplication of effort by differentiating the tasks requiring special technical expertise from those requiring knowledge and understanding of CAS, FAR, and the contract clauses.

Review Planning. The DCMC CIPR reviews are poorly planned and resources (29 I/P Specialists) are not allocated to yield the best results. The reviews are generally performed without a review program and typically focus on the verification of historical costs 2 to 3 years after the fact. The reviews do not evaluate budget estimates and contractor compliance with pension regulations, areas that could seriously impact the costs charged to DoD contracts. The evaluation of contractor budget estimates used for forward pricing proposals is of particular importance in the current environment in which contractors reorganize operations and, as a result, pension funds are restructured or transferred from a seller company to a buyer and budgeted pension costs may be significantly impacted. The Government should determine whether contractor-revised budget estimates are necessary and reasonable and whether pension plan changes and transfers comply with CAS and FAR requirements. The results of forward pricing and compliance reviews should provide contracting officers information essential to protect the Government's interests in negotiations.

Lack of Criteria to Prioritize Reviews. The DCMC CIPR offices do not maintain up-to-date inventories of contractors subject to CIPRs. Before our visit, only one of the three CIPR teams had updated its universe of contractors to reflect the revised requirements for conducting the reviews. The DoD raised the DFARS requirements for a CIPR to \$40 million from \$10 million of contractor-qualifying sales to the Government on May 17, 1995. According to data provided by the CIPR teams, the change reduced the number of contractors requiring CIPRs by one-third, from about 400 to 265. The teams also had little or no information to facilitate prioritizing the contractors for review purposes. One office had listed contractors according to sales dollars. However, although sales volume may indicate companies with large pension funds, sales alone is

Finding A. Contractor Insurance/Pension Reviews

not a sufficient indicator of whether a contractor represents high risk for review purposes. There is no correlation between the magnitude of sales and the adequacy of a contractor's internal control system. The results of DCAA accounting system reviews, internal control reviews, and other information must be considered.

Elements of Risk. The top 15 Government contractors alone require an estimated \$100 billion of pension fund assets to meet retirement liabilities for employees working on Government contracts (See Appendix C). Because fund contributions are financed through Government contracts and invested to meet current and projected liabilities, the accumulated assets are usually equal to, or exceed, the liabilities for the pension plan, or portion thereof, allocable to Government business. Any accumulated asset surplus should be maintained in the Government portion of the fund to defray future pension costs and should preferably transfer with the pension fund assets and liabilities that may transfer as a result of mergers or acquisitions. A surplus of assets can easily be eroded through changes in actuarial projections, new employee benefits, or other plan changes resulting in the need for new or increased pension fund contributions and revised expense forecasts. A divesting company may keep part or all of accumulated pension fund assets and liabilities. A buyer may have to establish a new pension fund to provide for future benefits or may want to merge a transferred plan with an existing plan. All scenarios impact future pension costs, and the CAS require compliance with specific provisions in each case.

Workpaper Documentation. The 34 completed CIPR files did not include adequate evidence to support the review conducted although the DCMC had implemented one of our prior recommendations and required all I/P Specialists to attend a training course on workpaper preparation. Some CIPR files contained only a collection of contractor benefit brochures and trustee financial reports. The I/P Specialist should have prepared workpapers to describe analytical procedures and criteria used to determine contractor compliance with regulations or actuarial assumptions. The DCMC reports do not describe the work performed to arrive at conclusions, and the reports typically contain little information about pensions other than to compare the annual pension costs to industry averages as a test of cost reasonableness. However, reasonableness alone is not a sufficient criterion for determining the acceptability of pension costs on Government contracts. The cost principles in FAR Subpart 31.205-6 encompass the criteria for determining the allowability of pension costs. The first requirement is that pension costs are measured, adjusted, and allocated in accordance with the Cost Accounting Standards. Therefore, compliance with CAS 412, "Composition and Measurement of Pension Costs," and 413, "Adjustment and Allocation of Pension Costs," is mandated by FAR and unrelated to whether a contract is covered by CAS.

Without workpapers, a person who needs to rely on the results of the CIPR will find no evidence to support the reviewer's judgments and conclusions and no basis for an expressed opinion on the contractor's pension plan. GAS mandate the preparation of workpapers. However, the GAS do not apply to non-audit disciplines, and the I/P Specialists do not comply with GAS.

Coordination. Although the DCMC agreed to a prior recommendation (see Appendix B) to develop a review program to define all required tasks to be performed by auditors and I/P Specialists, the Agency still has no program for review of insurance and pension costs to guide and coordinate the team work.

The DCMC has also not revised its standard request for audit assistance. The DCMC request for assistance only asks DCAA to verify contractor insurance and pension costs and related allocations to the contractor's books and records. A verification of costs to the books and records does not include audit procedures to determine contractor compliance with Government regulations. The DCAA performs the verification procedures as requested and rarely expands its audit coverage beyond that requested. Thus, the CIPRs are incomplete and do not protect the Government's interests in allocating, measuring, and assigning pension costs to accounting periods.

Position Description and Training for Insurance/Pension Specialists

Reviewers of pension plans must possess some actuarial knowledge and understanding of plan funding and employee benefits management to determine contractor compliance with CAS 412 and CAS 413. The reviewer must also understand cost accounting principles.

Defense Logistics Agency Job Guideline. The position description for Insurance/Pension (I/P) Specialists is in the DLA Agency Job Guideline for a GS-1163-12, Insurance Examiner. The guideline is based on the Office of Personnel Management description for job classification series GS-1163, Insurance Examiner, but the DLA revised the classification to incorporate requirements for pension plan knowledge and experience.

The DLA job description is unrealistic because the dual expertise requirement for a single employee does not exist in the employee market. Few, if any, I/P Specialists are hired with the knowledge and experience of both insurance and pension programs because few individuals possess the combined skills. To compound the problem, most insurance examiners are only trained in one insurance area, such as property and casualty or group insurance, and the DLA I/P Specialists are typically trained to review only casualty and property insurance. On-the-job training is also not available due to the lack of in-house capability. Moreover, the DFARS Subpart 242.73, Contractor Insurance/Pension Reviews, encourages combining the different and unrelated skills by requiring that they be applied in a single review.

Need for Differentiation of Skills. To properly match the availability of skills needed to review insurance and retirement programs, separate job classifications should be established for Insurance Examiners and Employee Benefits Analysts, and the programs should be covered in two different reviews. The separation of the two disciplines is consistent with industry practices. Contractors typically have an Employee Benefits Manager for the retirement program, including

Finding A. Contractor Insurance/Pension Reviews

pensions, savings plans, and group insurance plans. Management determines employee benefit levels and whether to insure or self-insure. A different Risk Manager handles the liability and property insurance and workers' compensation programs. The different forms of insurance vary greatly, but group insurance, such as life, health, and disability insurance, should be combined with pension plans for review purposes because it is an integral part of employee benefits.

Conflicting Audit Guidelines

The DFARS Subpart 242.73 assigns primary CIPR responsibilities to the I/P Specialist and does not adequately address how the auditor should reconcile a subordinate role on the CIPR team with the audit responsibilities outlined in FAR Subpart 30.2, "CAS Administration," or the GAS. To fulfill their responsibilities under FAR and for testing contractor compliance with the CAS, auditors need to independently establish their audit plans. The GAS hold the auditor responsible for establishing the scope of review and for documentation and test requirements. However, in the case of CIPRs, the DCMC I/P Specialists rather than the auditor establish the scope of work to be performed.

Comprehensive CAS Compliance Audits. At four major contractors where DCAA provided assistance to the CIPR team, the DCAA had not completed audits to determine contractor compliance with all provisions of the CAS governing pension costs. Although 11 of 32 audit files related to CIPRs included the DCAA standard audit program on pensions, the programs were only annotated to indicate which procedures would be performed by the DCMC CIPR team leader or cross-referenced to other CIPR-related assignments that evidenced incurred cost verification. One DCAA file documented unsuccessful attempts to coordinate its assessment of needed coverage with the DCMC team leader. The DCAA file also documented high audit risk for pensions and recommended annual pension reviews. Failure to periodically test contractor compliance with all CAS provisions will result, at best, in untimely detection or nondetection of noncompliances with possible material cost impact.

CAS Noncompliance Audit Reports. Three of the 32 DCAA audit reports and supporting workpaper files evaluated covered significant CAS noncompliance issues related to pension plan transfers or changes as part of contractor mergers, acquisitions, or divestitures. The DCMAO New York CIPR office provided technical support to the DCAA audits. The audits were comprehensive, well-documented, and coordinated with the DCMC and other audit offices. The three audit reports involved contractor failure to comply with specific criteria of CAS 413 and resulted in material findings. However, noncompliance audit reports on singular noncompliance issues do not replace the need for comprehensive CAS compliance testing with all criteria in an audit established for that purpose.

Audit Responsibilities Under FAR and DFARS. The FAR Subpart 30.202-7(b) specifically requires the contract auditor to conduct a detailed review to determine whether contractor-disclosed accounting practices comply with the

Finding A. Contractor Insurance/Pension Reviews

CAS and FAR. However, as a subordinate member of the CIPR team, the auditor must, as a practical matter, limit review procedures to those requested by the CIPR team leader to avoid duplicative coverage. The subordinate audit role is incompatible with the GAS requirement that auditors maintain an independent attitude and appearance in all matters relating to the audit work.

According to DFARS Subpart 242.7301(b), the DLA is the DoD Executive Agency assigned responsibility for CIPRs at all contractor locations meeting the criteria for the review. Paragraph 242.7301(d) stipulates that:

The CIPR should be the only formal review of a contractor's insurance/pension program . . . If any organization believes that additional reviews of the contractor's insurance/pension program should be performed, that request should be conveyed to the ACO. The ACO should perform the review as part of an ACO-initiated review, of [sic] if possible, as part of the CIPR if one is scheduled to be conducted in the near future. [Underscoring added]

Subpart 242.703(b) assigns responsibility to the I/P Specialist for, among other duties, heading the team that conducts the CIPR and maintaining complete documentation for CIPR reports. The DCAA auditor is responsible for participating as a member of the CIPR team, submitting information and advice to the team, and issuing an audit report for incorporation in the final CIPR report. The DCAA verifies historical costs as requested to contractor books and records.

Because the CIPR team leader assigns the work to be performed by the joint DCMC/DCAA team, auditors are not independently establishing the scope of audit or the audit tests and procedures to be performed in accordance with GAS. The DCMC only requests the auditors to verify historical costs to the contractors' accounting records, and the DCAA auditors must then rely on the DCMC to conduct tests for compliance with CAS. Although the DCAA is required to audit all incurred costs for compliance with CAS, it is restricted from doing so in the CIPR to avoid duplicating the coverage and violating Government policy.

Reliance on Work of Others. When relying on the work of others, the GAS require auditors to have a sufficient basis to do so. In the case of CIPRs, contract auditors would be required to determine the sufficiency, relevance, and competence of the evidential matter the I/P Specialists obtained. However, strict compliance with the auditing standards is not possible in the case of CIPRs because other team members are not required to comply with GAS. The problem is compounded because DCMC I/P Specialists do not prepare workpapers and, therefore, are not able to comply with auditor requests for shared documentation.

Finding A. Contractor Insurance/Pension Reviews

Timeliness of CIPRs

CIPR reviews must be conducted whenever significant changes occur in contractor business operations. Changes in business operations typically affect forward pricing rates used to price future contracts. Thus, special forward pricing CIPRs should be emphasized over biennial incurred cost reviews when a contractor has been involved in a merger, acquisition, or divestiture.

Scope of Biennial CIPRs. The DFARS 242.7302(b) stipulates that a CIPR shall be conducted at least every 2 years for contractors who meet the threshold requirements. The DCMC performs the required biennial reviews, focusing on costs incurred several years before the year in which the review is performed. A CIPR conducted in 1996 will encompass costs incurred by a contractor in 1993 and 1994. Recent business acquisitions, mergers, and divestitures that impact the pricing of future contracts are, therefore, not included in the scope of the biennial review. Based on the 2-year cycle, 3 years could elapse before a major event affecting contract pricing is reviewed.

Timeliness of Completed Reviews. Our sample of 34 DCMC CIPRs included 19 recently completed reviews of contractors involved in one or more acquisitions, mergers, or divestitures from August 1992 through December 1995. The DCMC had performed timely, special reviews of pension plan transfers in just four of the 19 cases. The Defense Contract Management District (DCMD) West Chicago had completed a special CIPR for two of nine contractors under its cognizance, and the DCMD West Los Angeles had completed special pension reviews for two of six contractors. The Defense Contract Management Area Office (DCMAO) New York commented on several other such cases in memorandums to contracting officers but did not test contractor compliance through an examination of accounting books and records.

DCMAO New York. The New York office had responsibility for CIPRs on 23 of 41 companies involved in business combinations (See Appendix A) and provided technical advice to contracting officers on most of the 23 acquisitions and mergers and also on other reorganizations under the cognizance of the DCMD West. Only four of the 23 were in our sample of 19 major contractors because New York had completed few formal reviews subsequent to a recent business combination. Although technical advice is essential, it does not substitute for an audit of a contractor's books and records in accordance with GAS. The GAS require that tests be performed to determine compliance with Government regulations and provide a comprehensive evaluation to support contracting officer decisions on the complex considerations involved in a reorganization.

Need for Timely Reviews. The regulations do not adequately emphasize the need for timely, special CIPRs, and Administrative Contracting Officers (ACOs) do not always request them as reported in Evaluation Report No. PO-96-012, "Department of Defense Oversight of Defense Contractor Business Combinations," June 28, 1996 (See Appendix B). The DFARS Subpart 242.7302(b) merely states a more frequent review cycle than 2 years may be appropriate for insurance and pension programs under certain circumstances.

Finding A. Contractor Insurance/Pension Reviews

Paragraph 242.7302(c)(2) further states that a special review may be performed when information reveals a deficiency or major change in the contractor's insurance/pension program.

The DFARS should be strengthened to emphasize that special reviews of insurance and employee benefit programs not only "may" but should be performed after events such as major contractor reorganizations, submissions of forward pricing proposals with long-term economic impact, or any other significant event that would impact long-term budget forecasts. Because business mergers and acquisitions result in pension plan transfers from a seller company to a buyer, or a buyer will have to establish a new pension fund, the DoD should place a high priority on the need for special reviews of plan transfers. A seller may also have created a special reserve account for workers' compensation or employee health benefits, and contracting officers need to be informed about the planned treatment of those reserves as part of a business reorganization.

Unless significant events are evaluated on a timely basis, unrealistic estimates of insurance expenses and pension fund contributions may be priced into new contracts with excessive costs charged to the Government. A forward pricing audit is more likely than an incurred cost audit to reveal problems in a timely manner, and early identification facilitates the resolution and disposition of questionable costs.

Material Weaknesses

According to the DoD Directive 5010.38, "Internal Management Control Program," a material weakness exists if management controls do not provide reasonable assurance that program objectives are being met, and the condition, therefore, requires the attention of the next level of management. One factor to consider is whether the condition could result in potential loss of significant funds or resources because of inadequate safeguards against fraud, waste, or mismanagement. In this case, the Government has created safeguards in the form of required CIPRs and regulations governing the allowability of pension and insurance costs. However, the safeguards are not being properly applied because the CIPRs inadequately test contractor compliance with the regulations. Due to the lack of adequate reviews and technical advice, contracting officers also do not have timely, accurate, and reliable information to determine whether contractors allocate Government-funded pension assets in accordance with the CAS and whether billions of dollars in pension fund assets will be available to offset future pension costs on novated contracts.

Transfer of Program Responsibilities

The GAS dictate that auditors use a disciplined approach to their reviews and that they possess adequate professional training and proficiency for the audits performed. Internal control risk must be assessed, and the work must be properly planned, supervised, and documented. The GAS provide a framework and structure for conducting audits to ensure that Government funds have been properly accounted for. Because auditors are required to comply with GAS, the responsibility for reviewing contractor compliance with the CAS and FAR governing pension programs should be transferred to the DCAA. Auditors should perform the necessary compliance testing with the assistance of DCMC specialists as needed.

Auditors are trained to plan their reviews and are able to conduct timely audits, concentrating on areas of greatest risk when insurance programs and pension plans transfer and contracts are novated. Reviews of forward pricing and changes in contractor expense allocation methods should have high priority. The DCAA maintains audit offices at major contractor locations, which facilitates the effective planning of reviews because the results of other audits can be used to assess the risk inherent in pension and insurance accounting. The other audits enable the auditor to tailor the scope of a particular review to specifically address high risk areas such as those created by reorganizations. Because the DCAA auditors are required to comply with GAS, they will provide a disciplined, systematic approach to the reviews. The DCAA is a separate audit agency within the DoD and provides advice to contracting officers in audit reports subject to the requirements in DoD Directive 7640.2, "Contract Audit Followup." The independent audit advice combined with followup requirements provide a system of checks and balances in the contract administration process.

Other benefits of DCAA performing the reviews include the availability of its Defense Contract Audit Institute for developing and disseminating training courses. The Agency recently developed a 1-week course on the revised CAS governing pension costs and also revised the DCAA Contract Audit Manual (CAM) guidance on pension costs in September 1996. The new guidance implements recommendations in our Report No. APO 93-011. The purpose is to instruct auditors on the requirements in accounting for pension costs on Government contracts. Although the DCAA auditor is trained to interpret and apply all CAS principles, the auditor has no technical background in insurance, pensions, or employee benefits management that is essential to interpret certain CAS or FAR criteria. A team approach with a contract auditor and employee benefits or insurance specialist is, therefore, needed to fully evaluate the programs.

To facilitate team work during employee benefits reviews, technical advisors should be part of the organization responsible for managing those reviews. Neither the DCMC nor DCAA currently employs any employee benefit specialists. Most likely, only a few advisors are needed to support the audits of employee benefits, and the agency conducting the audits can readily determine the proper allocation of their services as needed. The DCMC currently has 29

Finding A. Contractor Insurance/Pension Reviews

insurance specialists and can continue to provide technical advice on insurance matters to contracting officers and auditors. However, the number of insurance specialists could be reduced if the DCMC does not have primary responsibility for the reviews.

As noted in Finding B., the transfer the responsibilities for planning and managing audits of contractor employee benefit programs, including pensions, to the DCAA would ensure issues found during the reviews are cited in contract audit reports that advise contracting officers on the FAR and DFARS requirements for the resolution and disposition of CAS and FAR noncompliances. Such deficiencies must be a matter of formal record and accounted for by appropriate contracting officer dispositioning. The DCAA uses a systematic audit approach that would provide such accountability and better protect the Government's interests.

Summary

The current CIPR program is ineffective. As performed by non-auditors, the current insurance/pension reviews are poorly planned, documented, and coordinated and, in many instances, untimely. Because the DoD does not employ enough trained employee benefits specialists, contracting officers do not receive adequate expert information on the impact of business acquisitions and mergers on future employee benefits costs.

The lack of adequate review coverage for Government-funded pension assets presents a high risk. Defense contractor pension plans are typically fully funded, and often overfunded, in contrast to many underfunded commercial plans. One reason is that pension fund contributions are fully reimbursable expenses on Government contracts, provided the contribution meets CAS criteria and is made within the time stipulated for tax purposes. Contractors, therefore, have an incentive to make timely contributions. The Government must ensure the paid-in funds are available to cover pension costs on future Government contracts. If a contractor transfers employee benefit liabilities without all related pension fund assets, the transferee has to make new contributions to the pension fund. Because those contributions will be passed to the Government as period pension costs, the Government may pay twice to fund employee pensions.

Management Comments on the Finding and Evaluation Response

The DLA provided the following comments on the finding. For the full text of the DLA comments, see Part III.

Finding A. Contractor Insurance/Pension Reviews

DLA Comments on the Finding. The DLA partially concurred with our finding that CIPRs do not test contractor compliance with complex regulatory provisions, and the biennial reviews are not timely to meet Government needs. To remedy the problems, the DLA agrees to develop a joint review program with the DCAA. However, DLA nonconcurred with our conclusion that Finding A constitutes a material weakness under DoD Directive 5010.38. The DLA states the 34 CIPRs we reviewed did not encompass a number of risk-based special reviews because many of those were not done as formal CIPRs. For example, the DCMC New York office performed 27 special reviews in FYs 1995 and 1996, which included 11 requests on forward pricing. The DCMC Headquarters Overhead Team, including a staff pension actuary, together with CIPR team members has provided assistance to contracting officers and auditors working business combination issues, supported litigation where appropriate, and formed a Pension Tiger Team with DCAA to develop overall strategy and guidance in the area. Though those efforts did not result in a formal CIPR, they provided timely support to contracting officers.

The DLA concludes that the Inspector General considers the top 15 Government contractors to constitute the greatest DoD risk in terms of dollar value of pension funds, particularly for mergers or acquisitions. Because those contractors have been the focus of DCMC efforts, DLA requests that the "material weakness" finding be removed from the formal report.

Evaluation Response. It is premature to remove the material weakness finding before implementation of the joint review program and before we have had an opportunity to review the new program for its effectiveness. We plan to evaluate the program as DCMC and DCAA develops and implements it. Also, while we found that the DCMAO New York office had provided technical advice to contracting officers and auditors on numerous mergers and acquisitions, the rendering of technical advice is not a substitute for an audit no matter how expert the advice.

As explained in Appendix A, "Sampling Methodology," our universe consisted of 41 contractors involved in mergers and acquisitions over 3 years. We selected our judgment sample from CIPRs completed on the 41 contractors in the universe and found that few were completed, as DCMC agrees in the response comments. The DCMC claims the DCMAO New York office provides significant technical advice to contracting officers and auditors, and our report acknowledges the extensive contributions of that office. However, our finding relates to the usefulness of the CIPR program as it is now prescribed in the DFARS. The program is not working because technical specialists do not perform audits and also do not always provide essential technical information to auditors during the regularly scheduled CIPRs. The most successful part of the CIPR program has been through the type of technical advice DCMAO New York has provided to contracting officers and auditors for incorporation in audit reports. Those procedures should be formalized.

The DLA comments misinterpret our illustration involving the top 15 Government contractors. We used 15 as a convenient and sufficiently large number of contractors to use in our illustration of the amount of assets that are accumulated in a pension fund. We also noted that the largest contractors in

terms of sales do not necessarily constitute the largest risk for review purposes. A medium-sized contractor with severe internal control problems, such as DCAA may have identified, can constitute a far greater risk than a large contractor with an internal audit staff that coordinates with the Government, where good accounting controls are in place, and no organizational changes are planned. The number of contractors to include in a CIPR universe would have to be defined using risk factors to include materiality, but the number should not be based solely on that criterion.

Recommendations, Management Comments, and Evaluation Response

Redirected, Revised, and Added Recommendations. As a result of management comments, we added Recommendations A.1.c and A.2.c to clarify audit responsibilities in joint reviews and Recommendation A.2.d to require the results of technical reviews to be incorporated in DCAA audit reports. We also added Recommendation A.3 to require DCAA to comply with GAS and FAR audit responsibilities when participating in joint reviews of contractor insurance and pension programs.

A.1. We recommend that the Director, Defense Logistics Agency:

- a. Transfer the primary responsibility for audits of contractor insurance and employee benefit programs to the Defense contract Audit Agency.**

DLA Comments. The DLA nonconcurred and believes the best course of action is to combine the DCAA auditing and accounting expertise with the DCMC specialized technical expertise in a joint DCMC/DCAA review program. The joint program is expected to resolve the coordination problem between the two agencies and facilitate the more effective practice of reviewing insurance and pension costs prior to the pricing of contracts rather than performing the routine biennial incurred cost reviews. The DLA plans to have the joint program in place by April 30, 1997.

According to DLA, neither the DCMC nor DCAA concur with our recommendation to transfer program responsibility to DCAA. Although the DCAA is responsible for testing compliance with CAS and FAR, insurance and pension costs are also governed by detailed Federal and state regulations requiring specialized knowledge and background. Therefore, the DCMC believes a joint DCMC/DCAA review program, wherein DCMC focuses on the reasonableness and measurement of costs and DCAA on the allocation and assignment of costs, constitutes the best approach to assure proper compliance testing and protect the Government's interests in those areas.

Evaluation Response. We conditionally accept the proposed actions based on the Director, Defense Procurement (DDP), and the DLA commitment to improve CIPRs and the DCAA reluctance to assume primary responsibility for

Finding A. Contractor Insurance/Pension Reviews

the CIPR program. Acceptance of the proposed action is conditional to DLA also implementing the added Recommendation A.1.c. Because we recommended 4 years ago the improvements DDP and DLA now propose to implement, we plan to closely monitor new procedures to ensure they are timely and effective.

Moreover, a joint review program alone will not correct all planning and coordination problems. Review programs are frequently revised to fit the particular circumstances. If a technical specialist as team leader has the authority to unilaterally revise the joint review program to deemphasize audit procedures, coordination difficulties will continue and review coverage will suffer. Auditors need technical assistance to review insurance and employee benefit programs, and their responsibility is to determine the scope of the compliance testing required under FAR Subpart 30.2, "CAS Program Requirements," and FAR Subpart 30.6, "CAS Administration." The DCAA needs actuarial assistance to verify the measurement of total pension fund assets and liabilities. A technical analysis of the pension fund actuarial calculations and the risk associated with insurance coverage must precede the audit to determine whether insurance and pension costs are properly assigned to a cost accounting period, allocated to benefiting cost objectives, and allowable.

As with technical engineering subjects, the DCAA must be able to obtain the necessary technical advice from specialists and incorporate it in its audit reports on contractor compliance with Government laws and regulations. Technical specialists must also understand and acknowledge other audit requirements. When using the work of a specialist to obtain evidential matter, the Auditing Standards of Field Work require the auditor to obtain an understanding of the methods or assumptions specialists use to determine whether findings support related representations in the financial statements. The auditor must be able to determine the sufficiency, relevance, and competence of evidence obtained from the contractor and used by the specialist and make new or supplemental tests if necessary. The results of the technical review must be integrated with formal audit procedures that encompass appropriate compliance testing and documentation procedures to ensure that financial representations are reliable.

The following example illustrates the importance of this audit requirement. The DCMC performed a desk review of a major Defense contractor transfer of pension funds related to a 1993 sale of one of its divisions. The DCMC found the calculation of the transferred pension fund asset amounts reasonable and based on valid funding assumptions, but the evaluator did not test the data. Therefore, the technical advice rendered to the contracting officer was incomplete. The DCAA belatedly performed a CAS compliance audit of the pension fund transfers and found the seller had retained about \$200 million of surplus assets in noncompliance with CAS 413. The auditors drew that conclusion after a review of additional contractor data and examination of further evidence gathered to support their CAS noncompliance finding. Had the auditor simply relied on the initial desk review, the condition would not have been disclosed.

Finding A. Contractor Insurance/Pension Reviews

- b. Establish separate technical support teams for reviews of employee benefits.

DLA Comments. The DLA nonconcurred because the employment of two teams for review of contractor liability insurance (property and casualty) and employee benefit programs will require additional resources and result in two system reviews instead of one. The DLA believes that action would evoke strong criticism, especially considering current scrutiny of the extent of the DoD oversight of contractor operations.

Evaluation Response. The DLA did not offer an effective solution for accomplishing adequate reviews of employee benefit programs. To complete a comprehensive single CIPR, two technical specialists with different knowledge and skills will have to participate at the same time. Otherwise, the CIPR can only adequately cover one area, most likely casualty and property insurance, given the current DCMC staffing. Technical expertise in both subject areas will unlikely be available for a single, concurrent review. The DCMC currently employs 29 insurance specialists and only 2 or 3 individuals with actuarial knowledge to review employee benefits. Contractor reorganizations often result in pension fund transfers representing high risk for review purposes. Therefore, more reviews may be required of employee benefits than of liability insurance programs although fewer benefit specialists are available. The DCAA already establishes separate audit assignments for cost elements, such as insurance and pensions, governed by different Cost Accounting Standards and requiring entirely different considerations. The two areas are unrelated in regard to the skills required for evaluation. Therefore, we request the Director, DLA, to reconsider his position.

- c. Instruct technical specialists to provide the auditor, during a joint review, with the technical assistance necessary to meet audit requirements under the Government Auditing Standards.

Evaluation Comments. We request DLA comments on this new recommendation in response to the final report.

A.2. We recommend that the Director, Defense Procurement:

- a. Revise the Defense Federal Acquisition Regulation Supplement Subpart 242.73 to reflect the transfer of responsibilities to the Defense Contract Audit Agency and to separate insurance and employee benefits into distinct areas for review.

DDP Comments. The DDP nonconcurred with transferring review responsibilities from the DCMC to DCAA. However, the DDP agrees to issue a memorandum requesting that DCMC develop a joint review program with DCAA by April 30, 1997. The memorandum will also request DCMC to establish minimum acceptable workpaper documentation criteria and a program to improve the presentation of CIPR report findings to facilitate Contracting Officer resolution and disposition of findings on a timely basis.

Finding A. Contractor Insurance/Pension Reviews

The DDP did not believe that the transfer of responsibilities or the separation of insurance and employee benefits programs into distinct areas for review will correct deficiencies that stem from coordination problems.

Evaluation Response. The DDP proposed alternative actions that are only partially responsive. To correct the material weakness, additional actions are required. We added Recommendation A.2.c to require the DFARS to fully recognize the DCAA contract audit responsibilities.

A joint review program and proper workpaper procedures should improve planning, documentation, and coordination of specific review procedures but will not resolve the fundamental differences between audits and reviews performed by technical specialists. Further, audit responsibilities under FAR Subpart 30.2, "CAS Program Requirements"; Subpart 30.6, "CAS Administration"; and the Government Auditing Standards will continue to conflict with the limited responsibilities assigned auditors under DFARS Subpart 242.73. Government Auditing Standards of Field Work require auditors to obtain technical assistance in areas outside their expertise. Auditors may not relinquish their responsibilities for auditing and reporting to the technical specialists.

The current conflicting guidelines will cause difficulties in orchestrating the CIPR team work because they lead to misunderstandings between technical specialists and auditors regarding professional responsibilities. DFARS Subpart 242.7303(c)(3) requires the DCAA to issue an audit report for incorporation into the final CIPR report. A more rational sequence of coordination is to incorporate the results of the technical report into the audit report. A technical analysis of contractor measurements of total costs must precede an audit of the allocation, assignment, and allowability of those costs. Under current DFARS procedures, audit reports are usually attached to CIPR reports but because of the timing and limited information that DCMC expects auditors to provide, the DCAA reports do not contain meaningful information and are not useful. To avoid duplication and ensure the adequacy of reports, technical information should be incorporated into audit reports, not the reverse as DFARS currently requires. This change in procedures would permit sufficient time and latitude for DCAA to perform a complete audit for compliance with CAS. To accomplish that objective, we added Recommendation A.2.d.

We request the DDP final comments state the date by which it will issue the memorandum advising DCMC to implement the agreed-to actions.

b. Revise the wording in the Defense Federal Acquisition Regulation Supplement Subpart 242.7302(b) and Subpart 242.7302(c)(2) to require special reviews of contractor insurance and employee benefit plans before major contract awards, in conjunction with an in-depth overhead review, or subsequent to mergers, acquisitions, divestitures, and significant pension plan changes.

DDP Comments. The DDP concurred and will revise the DFARS to require risk-based, instead of biennial, reviews. The DDP agrees that it is cost-effective to include, as part of the risk-based review criteria, special reviews

subsequent to a merger, acquisition, divestiture, or pension plan change, when such events are anticipated to have a material impact on costs charged to Government contracts. Similarly, risk-based criteria should require a special review when a major contract is awarded or an in-depth overhead audit performed, but only if a review has not been performed recently or the contract award will not materially alter costs charged to Government contracts.

Evaluation Response. The proposed action is partially responsive to our recommendation. The response to the final report should specify the date by which the DDP will revise the DFARS.

c. Revise the Defense Federal Acquisition Regulation Supplement Subpart 242.73 to include a reference in Subpart 242.7301(d) to contract audit responsibilities under Federal Acquisition Regulations Subpart 30.2, "CAS Program Requirements," and Subpart 30.6, "CAS Administration," to require auditors to obtain the necessary technical advice from the Defense Contract Management Command to test contractor compliance with the Cost Accounting Standards governing insurance and pension costs.

Evaluation Comments. We request DDP comments on this new recommendation in response to the final report.

d. Revise the Defense Federal Acquisition Regulation Supplement Subpart 242.7303(c)(3) to require the results of technical reviews to be incorporated in Defense Contract Audit Agency audit reports on contractor compliance with the Cost Accounting Standards.

Evaluation Comments. We request DDP comments on this new recommendation in response to the final report.

A.3. We recommend that the Director, Defense Contract Audit Agency, direct auditors to comply fully with Government Auditing Standards and Federal Acquisition Regulations Subpart 30.2, "CAS Program Requirements," and Subpart 30.6, "CAS Administration," when participating in joint reviews of insurance and pension programs.

Evaluation Comments. We request DCAA comments on this new recommendation in the response to the final report. We are adding the recommendation to ensure auditors do not relinquish audit responsibilities to technical specialists.

Finding B. Administration of Reported Findings

Contracting officers did not achieve timely resolution of findings reported as a result of Contractor Insurance/Pension Reviews (CIPR) and did not process the reported findings in accordance with regulatory requirements. They did not have sufficient technical expertise or an adequate information system to settle complex issues in a timely manner and did not follow existing administrative requirements.

o Contracting officers required close coordination with technical advisors concerning complex pension issues. The CIPR reports provided insufficient data to resolve the issues and few advisors were available. Contracting officers were also inadequately trained to resolve and disposition pension issues.

o The data on CIPR reports in the Mechanization of Contract Administration Services (MOCAS) contract audit followup data base were not accurate and complete because the MOCAS access and security requirements prevented I/P teams from entering data as the CIPR reports were issued.

o Contracting officers did not follow the FAR and DFARS requirements to assess interest and penalties when CAS noncompliances and unallowable costs were cited in CIPR reports. They neglected to follow the administrative requirements because the CIPR reports failed to include the appropriate advice.

Failure to make timely disposition can delay the establishment of forward pricing rates and prompt settlements of final overhead rates. The lack of controls to ensure that all reportable CIPR reports are in the followup information system reduces the visibility of issues and increases the likelihood of delays in negotiating settlements.

Coordination With Technical Specialists

The DCMC contracting officers are responsible for the resolution and disposition of CIPR report findings and recommendations in accordance with the DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," August 16, 1995. The Directive also requires the Inspector General, DoD, to develop contract audit followup policy and monitor, coordinate, and evaluate DoD contract audit followup systems. The Directive defines contract audit and CIPR reports as overage if the contracting officer has not dispositioned all findings and recommendations within 12 months of the report date. The Directive also requires acquisition personnel to be adequately trained in the use of contract audit and CIPR reports.

Finding B. Disposition of Insurance and Pension Issues

Complexity of Pension Issues. Contracting officers had not closed 26 of 49 CIPR reports (53 percent) that contained findings and recommendations within the standard 12 months. Eight reports had been issued more than 2 years ago and were still open (Appendix D). The 26 overage reports questioned about \$97.7 million, including \$37.5 million representing pension costs. Although the pension issues did not result in the largest amount of questioned costs, they caused the CIPR reports to be overage in all but 4 of the 26 cases. The CIPR-reported pension issues were generally more complex than insurance issues because the evaluation of pension fund contributions and related pension costs involve both actuarial calculations and CAS criteria. Moreover, neither the actuarial nor CAS criteria were adequately addressed in the reports. Because the report findings were not clearly presented, contracting officers stated they needed technical advice from an employee benefits specialist to fully address the issues.

Of the remaining \$60.2 million questioned (\$97.7 million - \$37.5 million), \$50.5 million represented insurance costs questioned in one report alone. Insurance issues cited were generally related to administrative matters such as proper policy endorsements or to relatively simple allowability or allocability issues. Contracting officers were generally responsible for the delays in the resolution and disposition of insurance issues.

Need for Employee Benefits Specialists to Advise Contracting Officers. The DCMC hired a GS 1510-14, Actuary, to advise and coordinate on pension issues referred for resolution to DCMC Headquarters and the Office of the Secretary of Defense. The actuary also provides technical assistance to contracting officers. To help contracting officers resolve pension issues more timely, the DCMC is considering the establishment of two additional positions for employee benefits specialists, one at each DCMC District. The new positions can be established through a transfer to the District offices of 2 of the existing 29 positions and a reclassification of those positions from I/P Specialists to Employee Benefits Specialists.

Training for Contracting Officers. Although the DoD has developed courses that cover CAS and overhead issues, such as the DoD Cost Accounting Standards Workshop and the DoD Overhead Course, contracting officers need additional assignment-specific training to understand the impact of pension issues on forward pricing and final overhead rates and to effectively negotiate pension issues that arise. The training should be made available to Defense Corporate Executives, Corporate Administrative Contracting Officers, and Administrative Contracting Officers with responsibility for negotiating pension and other employee benefit issues.

Data Entry and Management Controls on CIPR Data in the MOCAS

The MOCAS, in combination with the followup requirements of DoD Directive 7640.2, "Followup Policy on Contract Audit Reports," serves as a

Finding B. Disposition of Insurance and Pension Issues

comprehensive followup system for tracking the status of CIPR reports with significant findings and recommendations. The Defense Logistics Agency Directive 5000.4, Contract Management, Part V, Chapter 12, "Contract Audit Followup," provides additional guidance.

Completeness and Accuracy of Followup Data. The DCMC District I/P teams listed 104 CIPR reports issued in FY 1995. Forty-two reports questioned costs of \$100,000 or more, which required they be tracked and reported in the MOCAS contract audit followup data base. The 42 reports questioned a total of \$297 million. However, the MOCAS contract audit followup data base for FY 1995 listed only 7 CIPR reports with questioned costs totaling \$41 million. Consequently, 35 CIPR reports questioning a total of \$256 million were not being tracked and reported in accordance with the contract audit followup requirements. Lack of comprehensive followup procedures leads to delays in settling issues as we found in our prior review and again in this review.

Delays in resolving outstanding issues also delay the establishment of forward pricing rates and the negotiation of final overhead rates. Further, the Government is not recovering funds that could be invested elsewhere. The cost to the Government of the lost investment opportunity can be estimated at an interest rate established by the Department of Treasury. During the 12 months ending June 30, 1996, the Treasury rate averaged 6 percent. On an investment of \$256 million, the Government could have earned about \$15.4 million.

Eight other CIPR reports issued before FY 1995 with total questioned costs of \$63.6 million cited findings that had not been dispositioned in accordance with the documentation requirements of DoD Directive 7640.2. After the new followup requirements for CIPR reports became effective on June 27, 1994, the reports should have been entered into the MOCAS but were not. The status of those reports should have been in the semiannual contract audit followup status reports DLA submitted to the Office of the Inspector General. We are, therefore, requesting followup information on the status of the \$63.7 million questioned in the eight CIPR reports listed in Appendix D.

Control Procedures. The DCMC reporting procedures originally required that I/P teams enter data on CIPR reports into the MOCAS when they were issued to the contracting officers responsible for resolution and disposition of the findings and recommendations. Following our discussions of this finding with DCMC Headquarters officials, the DCMC transferred the responsibility for entering CIPR data to the cognizant contracting officers. The DCMC also required that District Contract Audit Followup Monitors verify with I/P teams that all reportable CIPRs were entered into the MOCAS followup data base. The DCMC District offices informed their contract administration offices of this change and the requirement for validation of data. Those actions were responsive to our finding. Therefore, no recommendation is necessary with regard to establishing management controls for the completeness of CIPR data in the MOCAS.

Finding B. Disposition of Insurance and Pension Issues

Processing of CAS Noncompliances and Unallowable Costs Cited in Contract Audit Reports

FAR Part 30, "Cost Accounting Standards," establishes the administrative procedures the contracting officer shall follow to address reported noncompliances. DFARS Subpart 231.70, "Penalties for Unallowable Costs," requires the contract auditor to identify any unallowable costs subject to penalties and to recommend, with supporting rationale and documentation, that the contracting officer assess the penalties.

DCAA Audit-Reported Findings. The DCAA policy is to issue a separate contract audit report when a CAS noncompliance is found during a CIPR. The DCAA reports refer contracting officers to FAR and DFARS contract administration provisions for CAS noncompliances and unallowable costs and offer further audit assistance to the contracting officer. When DCAA audit reports cited CAS noncompliances discovered during CIPR reviews, contracting officers processed them according to the CAS administration procedures prescribed by FAR 30.602-2, "Noncompliance with CAS Requirements." Similarly, when unallowable costs found during CIPRs were subsequently addressed in contract audit reports, contracting officers generally processed the reports in accordance with DFARS based on the contract administrative advice in the audit report.

CIPR-Reported Findings. When CAS noncompliances and unallowable costs were cited in CIPR reports, contracting officers did not follow the requirements of the FAR and DFARS when settling the issues. For example, in six CIPR reports, CAS noncompliances were reported with estimated cost impacts to the Government of \$5.5 million. The CIPR reports included DCMC drafted sample letters for the contracting officer to use when informing the contractor of the review results. The sample letters cited the CAS noncompliances but did not express a formal "initial finding" of noncompliance or request cost impact proposals from the contractors as required by FAR 30.602-2, and the contracting officers responsible for negotiating the CAS issues did not modify the draft letters to comply with the FAR requirements. The contracting officer overlooked the noncompliances that were, therefore, not resolved. This deficiency will be addressed if the DDP implements Recommendation A.2.c to incorporate the results of technical reviews into DCAA audit reports on contractor compliance with the Cost Accounting Standards.

Management Comments on the Finding and Evaluation Response

DLA Comments on the Finding. The DLA concurred that additional efforts are needed to assure proper administration of reported CIPR findings. The DLA also stated it will strongly reemphasize MOCAS reporting requirements

Finding B. Disposition of Insurance and Pension Issues

for CIPRs and will make additional insurance and pension expertise available to Administrative Contracting Officers (ACOs) and price analysts.

Evaluation Response. The efforts by the DLA DCMC Overhead Center to improve administration and reporting of CIPR findings and to enhance its actuarial expertise should contribute significantly to timely resolution and disposition of these issues. We will monitor the DCMC efforts in this area as part of our followup on the report findings and recommendations.

Recommendations, Management Comments, and Evaluation Responses

Redirected and Revised Recommendations. We revised Recommendation B.1. to delete reference to the Career Management Board and add reference to the DCMC. We revised Recommendation B.2.a. to eliminate the reference to employee benefits specialists.

B.1. We recommend the Director, Defense Procurement, request the Defense Contract Management Command to provide pension training to those contracting officers who have or are anticipated to have significant pension issues for negotiation.

DDP Comments. The DDP concurred and will ask DCMC to provide pension training to those Contracting Officers who have or are anticipated to have significant pension issues.

Evaluation Response. The proposed action is partially responsive to the recommendation. The final comments to the report should state when the Director will issue the guidance to DCMC and the time table by which DCMC will be required to implement the training program.

B.2. We recommend the Director, Defense Logistics Agency:

a. Establish policy and procedures to ensure the Defense Contract Management Command Overhead Center provides administrative contracting officers with necessary advice in support of pension issue negotiations.

DLA Comments. The Defense Logistics Agency partially concurred, stating that, although it does not believe the best interest of DoD is to establish a separate employee benefits position, the DCMC Overhead Center will provide direct support and guidance to ACOs when they negotiate insurance and pension amounts. The DLA will develop policy and procedures by April 30, 1997, for providing the direct support and guidance. The DLA also will attempt to enhance its pension actuarial expertise by adding an actuary to the DCMC Overhead Center staff.

Finding B. Disposition of Insurance and Pension Issues

Evaluation Response. The proposed action is partially responsive to the recommendation. The final comments to the report should provide a time table and status report for hiring an additional actuary for the Overhead Center staff.

b. Direct contracting officers to develop milestone action plans for dispositioning the outstanding issues listed in Appendix D and report the status to the Office of the Assistant Inspector General for Policy and Oversight. If the reports have been dispositioned, provide supporting documentation.

DLA Comments. The Defense Logistics Agency concurred and has provided preliminary status information. The DLA will provide a final report by April 1, 1997.

Evaluation Response. The proposed action is responsive to the recommendation.

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Part II - Additional Information

Appendix A. Scope and Methodology

Scope

Contractor Insurance/Pension Reviews (CIPRs). We visited all three Defense Contract Management Command (DCMC) offices conducting CIPRs and reviewed the pension coverage in 34 project files involving 30 contractors. Nineteen of the 30 contractors represented had reorganized between August 1992 and October 1995. Files on other contractors were included to expand the evaluation because the CIPR teams had not issued recent CIPR reports on all contractors in our universe of recent mergers and acquisitions.

To determine whether a CIPR had been completed subsequent to a sale, acquisition, or merger, we compared the date of the event with the date of a subsequent CIPR report issued on any of the 30 contractors in the sample.

To evaluate the quality of CIPR coverage by the Insurance/Pension (I/P) Specialists, we reviewed documentation and background information in the project files supporting the CIPR reports.

To evaluate planning procedures, we reviewed CIPR team planning documentation and risk assessments. We also discussed the procedures with team leaders and I/P Specialists.

To determine the skills required, we reviewed Office of Personnel Management guidelines, DLA Agency Job Guidelines, and position descriptions for GS-1163-12 Insurance/Pension Specialists and discussed the results with a CIPR Branch Chief and team leaders.

Contract Audits. We visited four DCAA field audit offices cognizant of major contractors that had either recently expanded their business base through acquisitions or where the DoD was addressing significant pension issues. We reviewed 32 audit reports and workpaper files completed within the last 3 to 5 years in which DCAA documented audit support to the CIPR team or stated that contractor compliance with Government regulations governing pensions had been audited. We also reviewed audit planning procedures to determine whether DCAA prepared adequate risk assessments for audits of pension fund assets and liabilities. Finally, where DCAA had issued CAS noncompliance reports, we determined whether all relevant Government regulatory issues had been addressed.

Field work began in October 1995 and was completed in March 1996.

Disposition of CIPR Report Findings. The DCMC issues approximately 100 CIPR reports each year. We reviewed 51 CIPR reports issued from 1989

through 1995 at 15 DCMC contract administration activities. To understand the resolution and disposition of findings and recommendations in CIPR reports, we reviewed contracting officer file documentation.

Limitation on Scope. In a recently completed evaluation of DoD coverage of corporate issues that arise as a result of reorganizations, we visited eight DCAA field audit offices at major contractor locations. This evaluation confirms the results of our Report No. PO 96-012, "Department of Defense Oversight of Defense Contractor Business Combinations," June 28, 1996 (See Appendix B). As a result, we did not expand the number of field visits to the DCAA beyond four audit offices. The DCMC currently employs 29 GS-1163 I/P Specialists with insurance background. We did not evaluate the technical insurance expertise of I/P Specialists or the quality of the insurance reviews performed as part of the CIPRs. However, the conditions described in regard to the planning, documentation, and coordination of the reviews are the same for the pension and the insurance portions of the reviews although insurance and pensions require different technical knowledge and skills.

See Appendix E for a complete list of organizations we visited or contacted.

Sampling Methodology

Universe for Evaluation of CIPRs. We used a DLA listing of 24 mergers and acquisitions that occurred between August 1992 and October 1995 and involved 32 major corporations. To expand the universe, we used correspondence files and the DCMD office inventories of CIPRs completed from 1993 through 1995 and identified nine additional contractors involved in acquisitions or divestitures.

CIPR Sample Selection. Because the defined universe of 41 contractors involved in mergers and acquisitions was small and 23 of the 41 contractors had corporate offices under the cognizance of the DCMAO New York, statistical sampling was not used. The selection criteria were contractor involvement in reorganizations or recency of issued CIPR reports. Based on those criteria, we selected 19 contractors for evaluation of CIPR coverage. We expanded the sample to 30 contractors by reviewing CIPR work related to known issues or requesting workpaper files completed after the I/P Specialists had attended a workshop on workpaper preparation. We previously recommended that I/P Specialists obtain training in workpaper preparation and documentation. The objectives were to determine whether known issues had been adequately pursued and whether I/P Specialists who attended the workshop had improved their documentation of work performed.

Selection of Audit Offices. The four audit offices were judgmentally selected. Two offices were cognizant of companies whose business had expanded greatly through acquisitions in recent years. The other two offices had raised complex pension issues in reports on contractor noncompliance with cost accounting standards.

Appendix A. Scope and Methodology

Universe for CIPR Reported Findings. The universe consisted of 600 CIPR reports issued to contracting officers at DCMC contract administration offices from 1989 through 1995. We were unable to use a statistical sample of those reports because, during the evaluation period, the DCMC was consolidating and relocating contract administration offices in response to reductions and realignments within the Defense industry. Field visits to the contract administration offices began in August 1994 and were completed in October 1995. Upon visiting the offices to which CIPR reports had been issued, we frequently found they had been transferred to other offices. As a result, we selected substitute reports for those in the sample that were not available.

Technical Assistance

The review was performed with the technical assistance of the Employee Benefits Analyst, Technical Assessment Division, the Office of Assistant Inspector General for Auditing. The analyst assisted in the review of CIPR reports, audit reports, and memorandums on pension issues to determine whether the reviewer had considered all regulatory and statutory requirements.

Appendix B. Summary of Prior Evaluations and Other Reviews

The Inspector General, DoD, has issued two reports discussing DoD oversight of Defense contractor pension plans.

Report No. PO 96-012, "Department of Defense Oversight of Defense Contractor Business Combinations," June 28, 1996. Pension issues become material when companies restructure through acquisitions, mergers, and divestitures. After those events, neither the DCMC nor DCAA performed timely reviews of contractor compliance with Government regulations governing pension plans. The Agencies did not perform reviews because contracting officers did not request them.

The DCMC agreed to issue policy directing Administrative Contracting Officers (ACOs) to request special CIPRs of both acquiring, divesting, or merging contractors in major business reorganizations when the assets and liabilities of a pension fund, or other accumulated fund, transfer. Provided the ACO requested an audit, the DCAA agreed to evaluate contractor compliance with CAS 413 after the sale of a business segment with a pension plan transfer. In its response, the DCAA referred to the DFARS requirement that the CIPR be the only formal review of a contractor's pension program. The DCAA also agreed to revise the Contract Audit Manual (CAM) on pension costs to identify contractor documents with significant information on pensions and to require field audit offices to maintain permanent file information on contractor pension plans.

Actions Taken: The DCAA revised CAM Section 7-600, "Pension Costs," September 10, 1996. We are evaluating the guidance for adequacy.

Report No. APO 93-011, "Department of Defense Oversight of Defense Contractor Pension Plans," May 7, 1993. The Office of the Inspector General performed the evaluation to determine whether DoD audits and administers Defense contractor pension plan costs using adequate procedures to protect DoD interests. The report stated that lack of comprehensive followup procedures led to delays in settling pension issues. Review coverage of pension plan transfers after corporate reorganizations was poorly planned, documented, and coordinated and the Government did not have adequate information on business events that impacted pension plans. We also found that review coverage of anticipated pension funding levels during forward pricing rate evaluations was inadequate.

To ensure timely and proper resolution of CIPR-reported pension issues, we recommended the Director, Defense Procurement, advise the CAS Board to clarify and elaborate on the concepts of business segment closing and the adjustment of previously determined pension costs as provided in CAS 413, "Adjustment and Allocation of Pension Costs." The DLA should develop a milestone action plan for resolving outstanding pension issues, issue guidance to contracting officers to enforce the Government's rights under the cost principles

Appendix B. Summary of Prior Evaluations and Other Reviews

when circumstances indicate constructive receipts of surplus pension fund assets by a contractor for any reason, and establish reporting procedures to include significant CIPR findings in the DoD contract audit followup system. The DCAA should issue audit guidance on how to implement CAS 413 and advise the ACO on the requirement to adjust previously determined pension costs on all CAS-covered contracts. The DCAA should also consider CIPR-reported findings of contractor noncompliances with the CAS and FAR for additional, related noncompliances with other regulations.

To ensure comprehensive review coverage of all significant business reorganizations, we recommended that DLA request DCAA assistance in testing for contractor compliance with the CAS; require ACOs to obtain from contractors publicly filed information on all company reorganizations and to request special CIPRs be performed immediately after a significant merger, acquisition, or divestiture; require ACOs to forward to DCAA all information obtained from contractors pertaining to CAS compliance; and comply with its own guidance on workpaper preparation. The DCAA should issue additional audit guidance on the impact of business reorganizations on pension funds.

To improve planning and coordination of CIPRs, the DLA should develop a review program jointly with the DCAA, share results of reviews of CIPRs with the DCAA throughout the review and coordinate the CIPR draft report with the auditors, attach assist audit reports to the CIPR report, and establish procedures for the timely dissemination of information between offices that relinquish or assume review cognizance of a contractor. The DCAA should require auditors who participate in CIPRs to take the DCAA-developed training course on the standards governing pensions, emphasize the need for timely issuance of audit reports, and establish procedures for the timely dissemination of information between offices that relinquish or assume review cognizance of a contractor.

Actions Taken. The CAS Board implemented the Director, Defense Procurement, recommendation to revise the standards governing pension costs. The revised CAS 412 and 413 clarified previously obscure areas but incorporate new requirements that are difficult for auditors to implement without the assistance of an employee benefit specialist.

The DCAA concurred fully or in principle with the recommendations and issued Agency guidance in the DCAA Contract Audit Manual. The DLA generally concurred with all recommendations except one and issued a memorandum for corrective actions to Commanders of Defense Contract Management Districts on July 28, 1993. The memorandum addressed seven recommendations to facilitate the resolution of CIPR-reported findings and to improve review coverage through aggressive pursuit of contractor information and ACO requests for DCAA audits. The DLA also issued instruction on June 17, 1994, directing Insurance/Pension (I/P) Specialists to enter reportable CIPR reports into the contract audit followup data base.

The DLA did not agree to revise its guidance to require ACOs to forward to the DCAA field office, for its review and consideration, all information obtained from contractors pertaining to contractor compliance with CAS 412 and 413 governing pensions and other Standards within the scope of the CIPR. The

Appendix B. Summary of Prior Evaluations and Other Reviews

DLA explained that the information was routinely available to the DCAA auditor as a team member or as a recipient of the CIPR report. As a result, because DCAA is not primarily responsible for audits of contractor insurance and pension costs, the ACO need only provide DCAA information if a CIPR is requested.

Repeat Findings. Although the DLA addressed several of our recommendations, the conditions that prompted the initial recommendations still exist:

- o The DLA has failed to develop a joint review program with DCAA although it agreed to do so. The lack of a review program seriously obstructs a coordinated CIPR team effort.
- o The DCMC I/P Specialists do not prepare workpaper documentation of their reviews.
- o DCMC requests for audit support during CIPRs do not specify that auditors should conduct compliance testing.
- o The DLA established policies and procedures for entering CIPR-reported findings in the contract audit followup data base. However, the information is incomplete and not useful to facilitate tracking and ensure timely disposition and resolution of findings.

Appendix C. Other Matters of Interest

Total Government-funded contractor pension assets amount to billions of dollars. As a result, the determination of defined benefit pension plan funding requirements and the accounting for plan assets and liabilities are a significant risk to the Government. The DCMAO New York estimated defined benefit plan assets required to cover benefits for a single employee total about \$216,000. That office also observed that Government contract work is generally more labor-intensive and frequently requires more highly paid skilled labor than commercial sector work. Therefore, pension assets and liabilities are proportionately higher in relation to Government sales than to commercial sales. The estimate of \$216,000 is based on final annual salary of \$50,000 with anticipated annual benefits at 50 percent, or \$25,000. An 8-percent interest rate, commonly used today for actuarial purposes, results in a mortality factor of 8.64 (1983 Group Annuity Mortality Table); $8.64 \times \$25,000 = \$216,000$. To cover future benefits for 500,000 employees (estimated number of employees of the top 15 Government contractors) working on Government contracts, about \$100 billion in Government-funded pension assets would be required. We believe that estimate is conservative.

As a result of the Defense industry downsizing through mergers, acquisitions, or divestitures, DoD contracts and assets, including pension funds, transfer from sellers to buyers. The Defense industry is also reorganizing and restructuring operations in efforts to reduce general and administrative expenses, including employee benefits. In the process, contractors revise actuarial assumptions and benefit levels and affect the values of pension fund assets and liabilities. If asset values decline or liabilities increase, new fund contributions may be required and pension costs in both current and future years are impacted. The Government may also be entitled to share in surplus pension assets that revert to a contractor for any reason.

Appendix D. Insurance and Pension Issues Found Before 1994 and Still Open as of December 1995

<u>Contractor</u>	<u>Date</u>	<u>Unresolved Amount (millions)</u>
National Forge	1990	\$ 1.3
Perkin Elmer	1991	4.5
Crane Company	1992	0.5
Morrison Knudsen	1993	52.9
SOPAKCO	1993	1.1
Ball Corporation	1993	2.6
BF Goodrich	1994	0.5
EMS Technologies	1994	<u>0.3</u>
Total Unresolved		\$63.7

Appendix E. Organizations Visited or Contacted

Office of the Secretary of Defense

Office of the Director, Defense Procurement

Office of the Under Secretary of Defense for Acquisition Reform, Defense Acquisition University

Defense Contract Management Command

Headquarters, Fort Belvoir, VA

Defense Contract Management District West - Chicago

Defense Contract Management District West - Los Angeles

Defense Contract Management Area Office - New York

Contract Administration Offices

Atlanta, GA

Cleveland, OH

Detroit, MI

Garden City, NY

Grand Rapids, MI

Hartford, CT

Indianapolis, IN

New York, NY

Philadelphia, PA

Pittsburgh, PA

San Francisco, CA

Seattle, WA

Springfield, NJ

Stratford, CT

Texas Instruments, Dallas, TX

Defense Contract Audit Agency

Austin Branch Office, TX

Loral Resident Audit Office, NY

Northern New Jersey Branch Office, NJ

Upstate New York Branch Office, NY

Appendix F. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Deputy Under Secretary of Defense (Acquisition Reform)
Director, Defense Logistics Studies Information Center
Under Secretary of Defense (Comptroller)
Assistant Secretary of Defense (Public Affairs)
Director, Defense Procurement

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Assistant Secretary of the Navy (Research, Development, and Acquisition)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
General Accounting Office

Chairman and ranking minority member of each of the following congressional
committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations

Non-Defense Federal Organizations and Individuals (continued)

House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Defense Procurement Comments



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000



Jan 21, 1997

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, POLICY AND
OVERSIGHT, DOD INSPECTOR GENERAL

SUBJECT: DoDIG Draft Report on the Evaluation of Department
of Defense Oversight of Defense Contractor Pension
Plans (Project No. 60C-0092)

In response to your memorandum of 22 October 1996, my
comments concerning the subject report are attached.

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement

Attachment

6

Defense Procurement Comments

**DIRECTOR, DEFENSE PROCUREMENT
RESPONSE TO
DoDIG DRAFT REPORT ON THE
EVALUATION OF DEPARTMENT OF DEFENSE
OVERSIGHT OF DEFENSE CONTRACTOR PENSION PLANS
(PROJECT NO. 60C-0092)**

RECOMMENDATIONS

RECOMMENDATION A.2.a.: That the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement Subpart 242.73 to reflect the transfer of responsibilities from the Defense Contract Management Command to the Defense Contract Audit Agency and to separate insurance and employee benefits into distinct areas for review.

DDP RESPONSE: Nonconcur. I do not believe that a change in responsibility or a separation into distinct areas for review of insurance and employee benefits will correct the deficiencies cited in the draft report. The deficiencies result from a coordination problem that cannot be resolved by transferring responsibility from one organization to another. Even if responsibility is transferred, DCAA would still need to coordinate its reviews with DCMC. DCAA and DCMC would still need to develop a joint program to avoid duplicative review steps and data documentation requests, DCAA would need to coordinate the draft report with DCMC, and the DCMC report would need to be attached to the Contractor Insurance and Pension Review (CIPR) audit report. Furthermore, coordination between DCMC and DCAA is needed for reviews of both insurance and employee benefits. Thus, establishing two distinct areas will not help to solve the coordination problem.

I believe the coordination problem can be resolved by implementing recommendations contained in your prior report on this subject. I therefore plan to issue a memorandum to DCMC, with a copy provided to DCAA, requesting the implementation of your prior recommendations. This memorandum will request that DCMC develop a joint review program, and coordinate that program with DCAA. DCMC will be requested to establish minimum acceptable workpaper documentation criteria. In addition, since Contracting Officers stated that CIPR reports were not closed out on a timely basis because the report findings were not clearly

Defense Procurement Comments

presented, I will recommend that DCMC establish a program to improve the presentation of the CIPR report findings.

I will request that DCMC develop the joint program, in coordination with DCAA, by April 1, 1997. This joint program will assign specific agency responsibilities for the major review areas. The joint program will also require DCMC and DCAA to share the results of the CIPR throughout the review, coordinate the draft CIPR report, coordinate on all Cost Accounting Standard noncompliance issues, and attach the audit report to the CIPR report.

I will also request that DCMC work with DCAA to develop workpaper documentation criteria that are sufficiently detailed so that an auditor can rely on the work of the DCMC insurance/pension specialist.

RECOMMENDATION A.2.b.: That the Director, Defense Procurement, revise the wording in the Defense Federal Acquisition Regulation Supplement Subpart 242.7302(b) and Subpart 242.7302(c)(2) to require special reviews of contractor insurance and employee benefit plans before major contract awards, in conjunction with an in-depth overhead review, or subsequent to mergers, acquisitions, divestitures, and significant pension plan changes.

DDP RESPONSE: Concur. I believe the DFARS requirements for CIPRs should be changed from biannual to risk based reviews. Resources are best used if reviews are based on risk, rather than requiring a review every two years. I plan to replace the DFARS biannual review requirements with a risk based review criteria.

I agree it is cost effective to include, as part of the risk based review criteria, special reviews subsequent to a merger, acquisition, divestiture, or pension plan change, when it is anticipated that such events will have a material impact on costs charged to government contracts. I do not believe it is cost effective to require a special review every time a contractor divests a segment or changes a pension plan provision. Materiality must always be a consideration.

Similarly, I agree that the risk based criteria should require a special review when there is a major contract award or an in-depth overhead audit, but only if a review has not been performed recently or it is anticipated that the contract award will alter materially costs charged to

Defense Procurement Comments

Final Report
Reference

Revised

government contracts. I do not believe it is cost effective to require a special review every time there is a major contract award, since such an award generally does not change the conditions under which the pension plan is operating (assumptions remain the same and there is no asset transfer/reversion). In addition, I see no reason to perform a special review as part of an in-depth overhead audit if a review has recently been performed.

RECOMMENDATION B.1.: That the Director, Defense Procurement, request the Defense Contracting Career Management Board to establish specific training requirements for administrative contracting officers in negotiation of pensions and employee benefit issues.

DDP RESPONSE: Concur. I believe that DCMC should develop a pension training program. This training program should be coordinated with DCAA. I do not believe it is an efficient use of resources for the Defense Career Management Board to require all Contracting Officers to have this pension training. I will ask DCMC to provide pension training to those Contracting Officers that have or are anticipated to have significant pension issues.

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY
REFER TO

DDAI

27 JAN 1997

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT POLICY AND OVERSIGHT, DEPARTMENT OF DEFENSE

SUBJECT: Draft Report on DoD Oversight of Defense Contractor Pension Plans, GOC-0092

Enclosed is our response to your request of 22 October 1996. Should you have any questions, please contact Dave Stumpf, 767-6261.

Oliver E. Coleman
OLIVER E. COLEMAN
Acting Chief, Internal Review Office

cc:
AQ

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**COMMENTS ON DOD IG REPORT ON OVERSIGHT OF
CONTRACTOR PENSION PLANS**

We believe the subject draft report highlights a number of areas of legitimate concern regarding DCMC's oversight of contractor insurance and pension programs. The Command proposes to take significant corrective actions, some of which were already underway when the report was received, to address these matters. However, we believe the draft report overstates or generalizes the extent of some problems, fails to identify or fully acknowledge certain activities taking place, and corrective actions that have already occurred, and recommends drastic changes in agency responsibilities and functions which are unnecessary to accomplish the goal of effective oversight of contractor insurance and pension programs. We also take strong exception to the IG's conclusion that *Finding A* constitutes a material weakness under DoD Directive 5010.38.

Finding A on Contractor Insurance and Pension Reviews (CIPRs) is primarily based on a review of 34 completed CIPR files obtained by the IG. Based on this sample, the IG asserts that CIPRs are not adequately planned, documented, or coordinated with the Defense Contract Audit Agency (DCAA); that the reviews are focused on incurred costs to the exclusion of forward pricing and other risk elements; that Insurance/Pension Specialists lack expertise in the pension area; that DCAA's reviews are limited by DCMC's authority in this area; and that DCMC does not perform timely reviews of pension and insurance programs in connection with contractor mergers or acquisitions. The report concludes that these deficiencies constitute a material weakness under DoDD 5010.38, and recommends that the primary responsibility for insurance/pension reviews be transferred to DCAA.

DCMC agrees that corrective action is required in the areas of review planning, documentation, risk assessment, pension expertise, and coordination with DCAA. Our responses to the recommendations will address the specific actions proposed. We would note, however, that the 34 reports reviewed did not encompass a number of risk-based special reviews performed by the CIPR teams, since many of these were not done as formal CIPRs. For example, the DCMC New York office performed 27 special reviews in FY 95 and FY 96; 11 of which involved requests on forward pricing.

We believe that the draft report inadequately acknowledges the intensive efforts DCMC Headquarters and the CIPR teams have expended on insurance and pension issues associated with mergers and acquisitions at the major contractors. The DCMC Headquarters Overhead Team and the Defense Corporate Executives (DCEs) and Contractor Administrative Contracting Officers (CACOs) assigned to contractors involved in business combinations have been extremely proactive in identifying these issues. DCMC hired a headquarters staff pension actuary, Mr. Patrick Ring, provided direct assistance by Mr. Ring and CIPR team members to the Administrative Contracting Officers (ACOs) and auditors working business combination issues, supported litigation where appropriate (the Gould ASBCA Case), and formed a Pension Tiger Team with DCAA to develop overall strategy and guidance in this area. Admittedly, these efforts did not always result in formal CIPR as the work product, but they do provide timely and

Defense Logistics Agency Comments

useful support to the contracting officers responsible for making decisions on these matters, a fact confirmed by overwhelmingly positive comments obtained in preparation for this response from DCEs and CACOs involved in business combinations.

The IG correctly points out under "Elements of Risk" that the top 15 Government contractors constitute DoD's greatest risk in terms of dollar value of pension funds, particularly in the event of mergers or acquisitions. It is exactly this group of contractors that have been the focus of our efforts with respect to mergers and acquisitions. Accordingly, we are requesting that the "material weakness" finding be removed from the formal report.

Neither DCMC nor DCAA concur with the recommendation to transfer program responsibility to DCAA. While recognizing DCAA's responsibilities for testing compliance with FAR and CAS, it must be understood that insurance and pension costs are greatly influenced by detailed federal and state regulations, e.g. workers compensation, requiring specialized knowledge and background. Furthermore, CAS 412, 413, and 416 are arguably the most technically complex of all the standards, involving terminology and techniques which are primarily directed to actuaries. For these reasons, we believe that a joint DCMC/DCAA review program, wherein DCMC focuses on the reasonableness and measurement of costs and DCAA on the allocation and assignment of costs, constitutes the best approach to assure proper compliance testing and protect the Government's overall interests in these areas.

Finding B looks at contracting officer administration of reported findings in CIPRs. The IG states that ACOs did not achieve resolution of issues reported, nor did they follow administrative requirements for unallowable costs or CAS noncompliance's associated with those findings. These failures are attributed to lack of background and training on the part of ACOs, insufficient data in the CIPR to resolve the issues, failure of the CIPRs to provide specific recommendations on administrative actions, and incomplete/inaccurate data in the MOCAS Contract Audit Followup data base. The IG specifically requests information on the status of eight CIPRs issued prior to FY 95 with total questioned costs of \$63.6 million which were not entered into MOCAS as of the cutoff date of their review.

DCMC concurs that additional efforts are needed to assure proper administration of reported findings. We believe that some of the corrective actions proposed for *Finding A* (i.e., development of a joint review program with DCAA, and a revised report format) should significantly improve the quality and usefulness of reports being issued. We also foresee that in the future, CAS noncompliances will generally be addressed through DCAA audit reports, reducing the need for entering CIPRs into MOCAS.

As noted in the draft report, the DCMC requirement for ACOs entering reportable CIPRs into the MOCAS audit followup data base is relatively new (1995). Our review of this finding disclosed that most ACOs are not familiar with this requirement and view the MOCAS audit followup data base as consisting exclusively of DCAA audits. We do not agree with the IG's computation that we are at risk for the full amount of the interest on all reportable FY 95 CIPRs not entered into the followup system, since it is likely that many of those findings were resolved and disposed of without reporting. Nevertheless, MOCAS requirements for CIPRs will be

Defense Logistics Agency Comments

strongly reemphasized, and proper reporting can be expected to have a positive effect on timely resolution and disposition. Due to their complexity, insurance and pension issues will probably continue to be more time-consuming to resolve than other audit issues, particularly those that involve pension asset adjustments under CAS 413.50(c)(12), the area under litigation in Gould.

The need to make technical expertise in the insurance pension area, as well as other complex areas of overhead management, available to ACOs and price analysts throughout the organization has been recognized by DCMC in the creation of an expanded DCMC Overhead Center in December 1996. The new Overhead Center is chartered as a field organization located at Ft. Belvoir, VA, with the capability of leveraging Command resources to provide hands-on help in resolving problems. The Overhead Center will change the focus of CIPRs from biennial incurred cost reviews to risk based reviews. The three Insurance/Pension Team Chiefs and Mr. Ring will report directly to the Center, and will have the responsibility of implementing corrective actions proposed by this response. Furthermore, the Overhead Center will attempt to better enhance its pension actuarial expertise by bringing an additional actuary onto its staff.

Preliminary data on the status of the eight CIPRs referenced in Appendix D has been provided to Ms. Suzanne Servis of the DoD IG. The information provided indicates the ACOs have taken action to resolve reported findings in six of the eight reports referenced. One issue is in litigation; several others have been superseded by subsequent CIPRs or audit reports, and some require additional action. Ms. Servis has reviewed this information and provided followup recommendations which are currently under review.

Defense Logistics Agency Comments

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

FINDING A: Contractor Insurance/Pension Reviews (CIPRs) do not test contractor compliance with the complex regulatory provisions governing costs allocated to Government contracts, and the biennial reviews are not timely to meet Government needs. Lack of trained personnel to review pension plans, conflicting audit responsibilities, and inadequate administrative guidelines in the Defense Federal Acquisition Regulations Supplement (DFARS) contribute to the problem.

DLA COMMENTS: Partially Concur. The Cost Accounting Standards (CAS) addressing insurance and pension costs are arguably the most technically complex of all acquisition regulations. CIPRs need to be more closely linked to the specific needs of the individual contractor location relative to content and timing, based on joint Defense Contract Audit Agency (DCAA)/Defense Contract Management Command (DCMC) risk assessments and program planning. The newly established DCMC Overhead Center will set up an insurance/pension working group with DCAA to clarify respective responsibilities and develop a joint review program. This joint review program will eliminate the regular biennial incurred cost reviews and place additional emphasis on reviewing insurance and pension costs included in forward pricing rate proposals and pension cost adjustments resulting from segment closings. Administrative guidelines will be developed by the joint review team and incorporated into the DCMC One Book.

With respect to the material weakness finding under DoD Directive 5010.38, our discussions with your staff and our review of supplementary data contained in CIPR files indicated that projected pension costs were adequately reviewed in special segment closing or forward pricing rate evaluations. The results of these reviews were contained in special memorandum reports and therefore not included in your sample reports. Furthermore, it is important to note that DCMC Headquarters, CIPR team personnel, and DCAA have been intensely involved in surplus pension issues resulting from the recent wave of mergers and acquisitions. Most of these reviews dealt with contractors (referred to in the "Elements of Risk" section of the IG report) where the Government's risk was the greatest. These reviews have served not only to protect the Government's interest in these areas, but have also resulted in the Government obtaining waivers from CAS Board (CAS 413) whereby the Government was able to benefit from the application of hundreds of millions of surplus funds on current contracts. Therefore, we request the material weakness finding under DoD Directive be removed from the DoD IG report.

Internal Management Control Weakness: Nonconcur.

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

DLA APPROVAL:

Oliver E. Coleman
4/29/02 M-ccy

RAY W. McGOY
Major General, USA
Principal Deputy Director

Defense Logistics Agency Comments

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

Recommendation A.1.a: We recommend that the Commander, Defense Contract Management Command (DCMC), transfer the primary responsibility for audits of contractor insurance and employee benefit programs to the Defense Contract Audit Agency (DCAA).

DLA Comments: Nonconcur. As previously stated, the technical aspects of the Cost Accounting Standards (CAS) dealing with insurance and pension costs are very complex. Also, the measurement of insurance and pension costs are greatly influenced by complicated Federal and state laws and regulations, requiring specialized knowledge and background. DCMC believes the best course of action is to combine DCAA's auditing and accounting expertise with DCMC's specialized technical expertise via a joint review program. The joint review program will recognize DCAA's responsibility for reviewing allocation and assignment of insurance and pension costs, and DCMC's responsibility for reviewing the actuarial techniques of measuring those costs and reasonableness of actuarial assumptions and benefit levels. We believe the joint review program will lead to a more effective presentation to contractors regarding CAS noncompliances by addressing auditing and actuarial issues simultaneously. It will also resolve the coordination problem between the two agencies and facilitate the more effective practice of reviewing insurance and pension costs at time of forward pricing rather than performing the regular biennial incurred cost reviews. We plan to have this joint program in place by April 30, 1997.

A key element in the Government's ability to successfully review and challenge contractors' actuarial assumptions is the ability to attract certified actuaries. Two years ago, DCMC hired a pension actuary at its Headquarters. The Overhead Center has recently allocated resources to hire additional personnel trained in actuarial science to deal with actuarial issues arising from mergers and acquisitions. Transferring the CIPR function to the DCAA will present that agency with the same difficulties in attempting to attract, hire, retain and train actuaries that DCMC is currently addressing.

Disposition: Ongoing. ECD: 30 Apr 97

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

Oliver E. Coleman

DLA APPROVAL

RAY E. MCCOY
RAY E. MCCOY
Major General, USA
Principal Deputy Director

Defense Logistics Agency Comments

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

Recommendation A.1.b: We recommend that the Commander, Defense Contract Management Command (DCMC), establish separate technical support teams for reviews of employee benefits.

DLA Comments: Nonconcur. DCMC understands that some major contractors may employ separate management teams to handle both property/casualty programs and employee benefit programs. However, employing two different teams for reviewing contractor property and casualty programs and employee benefit programs will (i) require additional resources, and (ii) result in two system reviews instead of one. Taking this action would evoke strong criticism, especially in light of today's scrutiny of DoD's excessive oversight of contractor operations.

DCMC recognizes that the background and experience of the CIPR staff are primarily in the property and casualty insurance disciplines. An increase in knowledge and skills in the high risk areas of pension and retiree medical programs would be highly desirable. DCMC will aggressively continue its efforts to attract personnel skilled in actuarial science and to enhance the knowledge of the existing staff to the maximum extent possible.

DCMC has already strengthened the knowledge and competencies in analyzing actuarial assumptions by hiring a pension actuary and providing actuarial training to the CIPR team members. DCMC plans to pursue the hiring of additional pension actuaries: a second one at Headquarters; one in the Eastern District; and one in the Western District. DCMC is also exploring procuring an actuarial support contract if the Government's compensation package does not attract the requisite talent.

Disposition: Ongoing. ECD: 30 Jun 97

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

DLA Approval:

Oliver E. Coleman
May 2, 1997

RAY E. McGOWAN
Major General, USA
Principal Deputy Director

Defense Logistics Agency Comments

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

FINDING B: Contracting officers did not achieve timely resolution of findings reported as a result of Contractor Insurance/Pension Reviews (CIPR) and did not process the reported findings in accordance with regulatory requirements. They did not have sufficient technical expertise or an adequate information system to settle complex issues timely. They also overlooked existing administrative requirements.

DLA Comments: Partially Concur. Because of their complexity, the ultimate resolution of insurance and pension cost findings may take longer to resolve and disposition than other findings. This is especially true for those findings involving the segment closing adjustment under CAS 413.50(c)(12) which is currently under litigation, e.g., (Gould ASBCA case). Also, it is likely that some of the CIPR findings were resolved and disposed of without properly being recorded.

DCMC concurs that additional efforts are needed to assure proper reporting and timelier resolution of CIPR findings and recommendations. As a means to achieve the objectives, the CIPR Teams will now directly report to DCMC's Overhead Center. As the focal point of the CIPR program, the Overhead Center will strongly reemphasize contract audit follow-up of insurance and pension issues. By improving the actuarial capabilities, the Overhead Center will enhance the ACO's understandings of the technical findings which will lead to timelier resolutions of those issues. Furthermore, closer coordination with DCAA via a joint review program and shared training will result in better administrative compliance and ensure timelier disposition by presenting auditing and actuarial aspects to the ACO simultaneously.

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

Oliver E. Coleman

DLA APPROVAL:

Ray E. McCoy

RAY E. MCCOY
Major General, USA
Principal Deputy Director

Defense Logistics Agency Comments

Final Report
Reference

Revised

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

Recommendation B.2.a.: We recommend that the Commander, Defense Contract Management Command establish policy and procedures to ensure employee benefits specialists provide administrative contracting officers with necessary advice in support of negotiations.

DLA Comments: Partially Concur. We do not believe it is in DoD's best interest to establish a separate employee benefit specialist position. DCMC's newly established Overhead Center will provide direct support and guidance to ACO's when they are negotiating complex insurance and pension amounts. The joint review program will require DCAA and CIPR Team members to coordinate pension and insurance cost amounts to be used in forward pricing rates and final overhead rate settlements. We expect to develop policy and procedures by April 30, 1997.

Disposition: Ongoing. ECD: 30 Apr 97

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

Oliver Coleman

DLA APPROVAL: *4/29/97 - 4*

RAY E. MCGRATH
Gary S. Thurber, DDAI
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Defense Logistics Agency Comments

SUBJECT: DoD Oversight of Defense Contractor Pension Plans, 6OC-0092

Recommendation B.2.b.: We recommend that the Commander, Defense Contract Management Command direct contracting officers to develop milestone action plans for dispositioning the outstanding issues listed in Appendix D and report the status to the Office of the Assistant Inspector General for Policy and Oversight. If the reports have been dispositioned, provide supporting documentation.

DLA Comments: Concur. DCMC has started investigating the disposition of those outstanding issues listed in Appendix D and has already given preliminary information to the IG. The IG has responded with additional recommendations. DCMC will enter those CIPR report findings that remain unresolved into the MOCAS system and provide disposition memos for those CIPR report findings that have been disposed. We expect a final report will be submitted to the Office of the Assistant Inspector General by April 1, 1997.

Disposition: Ongoing. ECD: 1 Apr 97

ACTION OFFICER: Patrick Ring, DCMC-OHC, 767-3385

APPROVAL: Gary S. Thurber, Associate Director, Acquisition

COORDINATION: Dave Stumpf, DDAI, 767-6266

Oliver E. Coleman, Acting Chief, Internal Review Office

Oliver Coleman

DLA APPROVAL:

Ray E. McCoy
RAY E. MCCOY
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**C. Report's Point of Contact: (Name, Organization, Address, Office Symbol, & Ph #): OAIG-AUD (ATTN: AFTS Audit Suggestions)
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